



Utilities/Power

Investor feedback on utilities/power stocks - Part 2

Summary:

Since our initiation of coverage of the Utilities sector last week, we've collected various feedback from clients. As a follow-up to part 1 ([click here](#)), we offer additional perspectives on our coverage universe.

- **DTE's** midstream business continues to weigh on the stock's valuation though investors recognize DTE's exceptional financial track record plus some potential upside to the midstream earnings.
- Investors recognize that **EXC** and **PEG** do not currently reflect any value for their merchant power businesses, with little differentiation between both stocks, but see little incentive to support the names ahead of FRR decisions in IL/NJ and an update on a federal investigation of EXC's lobbying practices in IL.
- The recent short squeeze and upcoming regulatory updates are likely behind a strong outperformance of **AGR** and **PPL** vs. the XLU since our launch (+7.8% for AGR and +9.3% for PPL vs. +5% for XLU). The stories continue to face challenges, but AGR's NY rate case settlement should be filed any day now and the BOEM should update its review of the Vineyard Wind project in mid-June. Ofgem, the UK electric/gas utility regulator, should update its thoughts on allowed returns for electric transmission and gas distribution networks in late June, and that could be neutral to marginally positive for PPL, we believe.
- The recent rally among mid-cap stocks seems to have supported smaller water utilities, with **AWK**, our top pick for water names, trailing smaller names, **SJW** in particular, despite no fundamental updates. Among water names, AWK continues to attract most investor support, especially from those with an ESG mandate. Hedge funds remain attracted to **WTRG** given potential upside to gas earnings in PA and some expecting WTRG's gas earnings to gradually gain a water P/E multiple vs. the current 30% discount, we estimate. Investors recognize AWR's strong operational and financial track record despite a pension-related earnings hit in 1Q20.

Highlights

Regulated/diversified electric/gas utilities:

AGR (Neutral): The updated rate case settlement for AGR's NY utilities (NYSEG & RG&E) should be out any day and that, together with management's outreach has triggered a debate on AGR's bear investment thesis. In ME, AGR has filed a court challenge to the inclusion of the NECEC electric transmission project on the November ballot – a court decision would need to come out before September 11 when the ballots should be printed. Last week's FERC decision on the MISO electric transmission ROE and the methodology to set it has been widely seen as constructive by investors though more for AEP/FE rather than New England transmission operators (AGR/ES). The new methodology when updated for a 100 bps RTO adder would imply a wider range of reasonableness, with the high end 10.6-10.7%, we estimate. Challenges to FERC transmission ROEs for New England operators are still pending, they cover a different/earlier period (thus a higher interest rate environment) and FERC has not yet opined on additional non-RTO ROE adders and thus a cap on the all-in transmission ROEs for new projects. AGR currently earns ~11.3% in all-in transmission ROEs in CT and ME (vs. ~11.5% for ES), so we/investors don't see much (if any) downside to AGR's transmission earnings assuming higher incentive caps. Management still expects the BOEM to comment on the Vineyard Wind (VW) offshore wind project (a supplement to VW's Environmental Impact Statement) on June 12 and the Bureau to issue the final permit for the project in December 2020. Assuming no additional delays, we hope for some positive implications for AGR and ES.

DTE (Buy): Among all of our Buy-rated names, we had expected most constructive investor feedback on DTE given that the stock seemed to be trading even below the fair value of its regulated utilities (assuming a CMS-like P/E). The feedback has been mixed with the stock just marginally outperforming the XLU since our launch though gaining some strength this week. In general, investors recognize DTE's strong execution track record and its premium regulated utilities in MI. They admit that DTE's midstream business is less commodity-price sensitive than average, that it could benefit from higher gathering demand in the Northeast in 2021 and that NEXUS could see some longer-term contracts if/when ACP/MVP pipelines get delayed. Yet, an average investor would rather create a "synthetic DTE" by buying shares of CMS and a midstream business, though the latter would have to come at a negative equity value to truly reflect DTE's current valuation. We hope that with strong operational execution, no negative updates from Antero/Southwestern, and further construction delays for MVP/ACP the DTE stock should continue to re-rate through the end of 2020.

EXC (Buy)/PEG (Neutral): Investors don't see much difference between the two stocks or the reason to support either one any time soon. Neither implies any value for their respective merchant power businesses even though both should see some upside to their nuclear power earnings from IL and NJ eventually pursuing the FRR option outside of the PJM capacity market. For EXC, investors seem reluctant to support the stock ahead of an update on a pending federal investigation of Exelon's/ComEd's lobbying practices in IL or the November legislative session in the state where the FRR future could be decided. For PEG, though the company thinks no

legislation is needed for NJ to pursue an FRR option, the NJ BPU (state's utility regulator) is unlikely to opine on the FRR until early/mid-2021, we believe. In the meantime, PEG's electric transmission ROE should drop and the company is likely to pursue an equity stake in Orsted's Ocean Wind offshore wind project off the coast in NJ, likely intensifying the debate about the future of margins of PEG's gas plants in NJ/MD/CT.

PPL (Neutral): Investors seem unanimously surprised by our Neutral stance on the name despite ongoing FX pressures and the lack of growth prospects for PPL's US utilities until 2025 or beyond. Our Neutral rating was based a combination of somewhat fair valuation and our expectations that Ofgem's pending review of allowed equity returns for electric transmission and gas distribution won't result in an incremental reduction in the equity return (RORE) on the back of lower interest rates. The returns are still coming down however – starting April 2023, we'd expect the realized RORE for WPD to not exceed 9% vs. ~13-13.5% currently. Since our launch, PPL has outperformed the XLU by 420 bps and now the stock seems to imply a 37% premium to the 2022 EV/RAB for WPD assuming just a 5% discount to PPL's slow growing US utilities. The valuation yet again looks rich to us though PPL's 6% 2020 dividend yield does provide some support, and we believe the company could maintain the current level of dividends given lower regulated utility capex.

Water utilities:

AWK (Buy): Investors continue to like the story and, for once, few questioned AWK's current valuation premium vs. an average electric utility (~52% on our 2022 estimates). Investors appreciate how resilient the stock has been YTD (+0.7% vs. -8.7% for XLU and -5.4% for S&P 500). The heavy regulatory calendar for 2020 doesn't seem to worry investors.

AWR (Buy): Dedicated water utility investors recognize AWR's strong earnings/operational track record despite a large pension-related earnings hit in 1Q20. The high valuation premium we assign to AWR's (and AWK's) military contracts has received some debate, but overall we've heard little to no pushback to our bullish stance on AWR especially given growing volatility in earnings of AWR's peers in CA, CWT and SJW.

WTRG (Neutral): Hedge funds and some long-onlys remain attracted to WTRG given potential upside to gas earnings in PA and some expecting WTRG's gas earnings to gradually gain a water P/E multiple vs. the current 30% discount, we estimate. We recognize incremental cost levers on the back of the Peoples merger and that the look back repair tax application to be filed for the business in PA could deliver incremental earnings though it's tough for us to say how meaningful the EPS benefit would be after sharing with ratepayers. We do admit, however, that the stock does not currently discount any incremental earnings upside in PA.

Utilities/Power Disclosures

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Other Companies Mentioned in This Report

- Avangrid, Inc. (AGR: \$43.50, Neutral)
- American States Water Company (AWR: \$81.73, Buy)
- PPL Corporation (PPL: \$27.60, Neutral)
- Essential Utilities, Inc. (WTRG: \$42.87, Neutral)
- Exelon Corporation (EXC: \$38.38, Buy)
- SJW Group (SJW: \$61.38, Neutral)
- American Electric Power Company, Inc. (AEP: \$84.69, Buy)
- American Water Works Company, Inc. (AWK: \$123.72, Buy)
- DTE Energy Company (DTE: \$108.27, Buy)
- Public Service Enterprise Group Inc. (PEG: \$50.56, Neutral)
- Eversource Energy (ES: \$80.51, Buy)
- Utilities Select Sector SPDR Fund ETF (XLU: \$58.97)
- FirstEnergy Corp. (FE: \$42.26, Buy)
- CMS Energy Corporation (CMS: \$57.51, Buy)

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